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FEDERAL COMMUNICATIONS COMMISSION
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Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
Implementation of the	)	
Telecommunications Act of 1996:	)	CC Docket No. 96-150
	)	
Accounting Safeguards Under the	)	
Telecommunications Act of 1996	)	
	)	

REPLY COMMENTS OF SPRINT CORPORATION

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September 10, 1996

SUMMARY

The Commission's Joint Cost Rules must continue to apply to those BOCs which have chosen the highest productivity factor and no sharing under the Commission's price cap regulatory scheme. The umbilical cord to costs is not severed for such carriers. Moreover, price caps do not address the BOCs' ability and incentive to engage in discriminatory practices by exploiting their bottleneck control over the facilities and services which their rivals must continue to purchase.

The claim by the BOCs and USTA that there should be no exogenous treatment for reallocation of investment from regulated to nonregulated accounts is without merit. The current productivity-based X-Factor does not reflect all of the costs eligible for exogenous treatment and, in any case, exogenous treatment of such investment is necessary to ensure that the risk of the new service is not borne by regulated services.

Finally, the comments confirm Sprint's position that the use of a fair market value test for services is ill-advised. Even those parties who express some support for the use of a fair market value test for services recognize that such test is inherently subjective and easily abused.

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REPLY COMMENTS OF SPRINT CORPORATION

Sprint Corporation, on behalf of Sprint Communications Company L.P. and the Sprint local exchange carriers, hereby respectfully submits its reply in response to comments on the *Notice of Proposed Rulemaking* (*NPRM*) released July 18, 1996 (FCC-96-309) in the above-captioned proceeding.

I. PRICE CAPS

A. THE ELIMINATION OF SHARING UNDER PRICE CAPS DOES NOT ELIMINATE THE NEED FOR JOINT COST RULES.

The BOCs and USTA argue that the continued applicability of the Commission's Joint Cost Rules to LECs which have chosen the highest productivity factor and no sharing under the Commission's price cap regulatory scheme is unnecessary. According to these parties, such carriers operate under what can be -- or, at least, should be -- considered a "pure" price cap system and they have few incentives to misallocate costs. *See, e.g.,* Ameritech at 4-8; Bell Atlantic at 2; Nynex at 4-9; SBC at 49 and USTA at 5-9. Their arguments are without merit.

As Sprint explained in its initial Comments (at 16-18), the Commission's price cap regime, even for those carriers who elect the no sharing option, does not sever the umbilical cord to costs. Such carriers still are able to adjust their price cap indices by the exogenous costs that they incur. The Commission continues to monitor the productivity factor. And the BOCs are still required to report their earnings on a quarterly basis so that the Commission can ensure that profit levels are reasonable and not confiscatory.

The BOCs would have the Commission believe that their ability to make exogenous cost and productivity adjustments to their price caps indices provide little, if any, incentive for no-sharing carriers to engage in anticompetitive cross-subsidization. *See, e.g.,* Ameritech at 8 ("Ameritech is under no-sharing price caps in all of its jurisdictions, and the danger of monopoly cross-subsidy is eliminated in such circumstances."); Nynex at 6 ("...the availability of exogenous cost adjustments and adjustments to productivity factors [does not] detract from a pure price cap plan" because "these factors do not significantly link costs to rates.").[1] However, as Dr. John E. Kwoka, Jr.,

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[1] Ameritech cites USTA's proposal for a moving average X-factor as eliminating the need for periodic review of the productivity factor. Sprint has already explained why USTA's approach is flawed. See Comments and Reply Comments of Sprint filed January 11, 1996 and March 1, 1996 in CC Docket No. 94-1 (*Price Cap Performance Review for Local Exchange Carriers*).

one of the architects of the Commission's price cap regime, has testified before the Department of Justice in the MFJ proceeding, cross-subsidization always remains a problem where price is not completely decoupled from actual performance results.[2] Dr. Kowka explained that the "feedback" required by the Commission under its price caps regime to ensure that consumers are able to benefit from the incentives created by price caps for the BOCs to reduce costs and improve productivity and to adjust the caps in light of actual cost experience of the BOCs compromises the efficiency incentives created by price caps. Thus, although "price caps ... represent improvements on traditional rate-of-return regulation ... [t]he actual plan in place for the BOCs differs in significant and relevant ways from a pure price cap plan that would truly eliminate incentives for cross-subsidization." *Id.* at ¶6

Dr. Kowka also emphasized that "price caps do nothing to address the competitive concerns regarding discrimination" since a BOC "retains control of a bottleneck service that must continue to be purchased by its rivals in a different but related market" and is "quite capable of undermining those rivals through discriminatory practices." *Id.* at ¶49. Because of the BOCs

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[2] *U.S. v. Western Electric et al.,* C.A. No. 82-0192 (HHG), Affidavit of John E. Kowka, Jr. attached to Sprint's Opposition to Motion to Vacate filed November 16, 1994 before the Department of Justice ("Kowka Affidavit") at ¶¶31-48.

continued ability and incentive to engage in such practices, "[p]rice caps in actual practice -- as opposed to in some ideal form -- do not render unnecessary other restrictions on a regulated firm's behavior." Kowka Affidavit at ¶51. In short, price caps are not a panacea against anticompetitive cross-subsidization or discrimination and thus the Commission's Part 64 cost allocation rules remain an essential regulatory tool.[3] *See also* MCI at 39, LDDS WorldCom at 32, GSA at 6-8 and Public Service Commission of Wisconsin at 10-11.

B. EXOGENOUS TREATMENT FOR REALLOCATIONS OF INVESTMENT IS APPROPRIATE.

The BOCs and USTA claim that there should be no exogenous treatment for reallocation of investment from regulated to nonregulated accounts. They argue, for example, that the Total Productivity-based X-Factor "is designed to capture total company productivity growth, including nonregulated activities, provided

[3] There is no reason to adopt American Public Communications Council's (APCC) recommendation (at 15-18) to substantially increase the detail in the Cost Allocation Manual, to require additional attestations in the auditors' reports, or to change allocation methods. Nor is there any reason to adopt Telecommunications Resellers Association's suggestion (at 8) that the BOCs estimate anticipated costs of affiliate transactions on a quarterly basis. Such suggested requirements would impose significant costs on the carriers to modify existing procedures and systems. Moreover, they are unnecessary since as the Commission tentatively concluded in the *NPRM* (at ¶¶27 and 64), its existing Part 64 cost allocation rules and its affiliate transaction rules "generally satisfy the statute's requirement of safeguards to ensure that these services are not subsidized by subscribers to regulated telecommunications services."

on an integrated basis with regulated activities" and an exogenous cost adjustment would be duplicative, NYNEX at 33, fn. omitted, *see also*, USTA at 9; that such exogenous treatment would be a disincentive for the BOCs to develop new integrated services, Bell Atlantic at 12, NYNEX at 33-34 and USTA at 8; that that reallocations should be limited to instances of underforecasting of nonregulated costs; and, that should not be applied to a change in status to accommodate the application of Part 64 rules. Pacific Bell at 36-37, Ameritech at 9, and SBC at 50. These arguments cannot withstand scrutiny.

The Commission has recognized that "[a] properly designed X-Factor, such as one that is derived from a sound TFP [Total Productivity Factor], would recognize almost all of the costs for which exogenous treatment would now be accorded," *LEC Price Cap Performance* Review, 10 FCC Rcd 8961, 9089 (1995). However, such a factor has not yet been adopted, and the current X-factor does not reflect such costs. Clearly, until a revised X-Factor has been adopted, the X-Factor cannot be assumed to account for growth in nonregulated activities provided on an integrated basis or to substitute for exogenous treatment of such costs. Absent such a new X-Factor which properly accounts for the growth in nonregulated activities, the alleged double counting cannot occur.

The BOCs' claim that exogenous treatment of investment which is reallocated to nonregulated accounts will create a disincentive to develop new services is also ill-founded. If a new service that uses common plant is treated as nonregulated under Part 64, the associated costs and revenues should be allocated to nonregulated activities to insure that the risk associated with the new service is not borne by regulated services. This is merely a proper allocation of risk, not a disincentive. In any event, the reallocation applies only to existing plant that is used to create a new service, and not to any new investment.

Various BOCs argue that Section 61.45(d)(1)(v) is applicable only to underforecasts of the allocation of Central Office Equipment and outside plant investment and that it should not apply to a change in the categorization of a service from regulated to nonregulated. They are incorrect. When the Commission adopted its cost reallocation requirements, it specifically found that "the reallocation rules are essential to the integrity of a cost allocation system ... which seeks to prevent regulated activities from absorbing nonregulated costs, either at the start of a forecast period or subsequently." *Joint Cost Reconsideration Order,* 2 FCC Rcd 6283, 6291 (1987). A change in the categorization of a service from regulated to nonregulated implies a change in the forecasted nonregulated use of the investment from zero to some percentage. As with any other reallocation, the purpose of the reallocation here is "to prevent regulated activities from absorbing nonregulated costs."

Thus, such reallocations are properly treated under Part 61.45(d)(1)(v).

II. USE OF A FAIR MARKET VALUE TEST FOR TRANSACTIONS BETWEEN AFFILIATES INVOLVING SERVICES IS ILL-ADVISED

In its initial Comments (at 13-14 and Appendix A at 17-21), Sprint explained that because any attempt to establish the fair market value for services is inherently subjective, the use of such test could be easily abused and hamper the Commission's ability to guard against improper allocations and cross-subsidization. Several parties also point out the difficulty and expense that would be involved in ascertaining the fair market value of services and, like Sprint, urge the Commission to abandon its proposal in this regard. *See, e.g.,* NYNEX at 22; BellSouth at 32-34; USTA at 17.

Even the parties who otherwise support the use of a fair market value test for services recognize the potential for abuse such test would afford the BOCS and presumably other Tier I carriers. *See, e.g.,* MCI at 25 (expressing concern about the leeway provided the BOCs under such test to value their service transactions). These parties argue that if the Commission does adopt its proposed test, it will need to establish detailed criteria and procedures for such valuations and require the carriers to maintain records documenting the valuation methodology. *See e.g.,* AT&T at 16-17. But the fact that these parties believe that the Commission must prescribe the methods for estimating the fair market value of service transactions clearly demonstrates the danger involved in using such estimations. Sprint respectfully suggests that, instead of trying to develop such criteria and procedures which, of course, could not cover all possibilities, the Commission's time would be better spent by continuing to monitor the methods currently used for valuing service transactions and ensuring that such valuations are reasonable.

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CERTIFICATE OF SERVICE

I hereby certify that a copy of the foregoing **Reply Comments of Sprint Corporation** was sent by hand or by United States first-class mail, postage prepaid, on this the 10th day of September, 1996 to the people on the attached list:

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